Securities

Topic 5:

Legal environment – disclosure and compliance

FINANCIAL EDUCATION PROFESSIONALS

RG 146 Securities

Topic 5: Legal environment - disclosure and compliance

Version 18.2

CONTENTS

Topic outcomes

On completion of this topic, participants should be able to:

- Explain why the financial services industry is regulated in Australia
- Outline who regulates the different parts of the financial services industry
- Summarise the major changes in financial services regulation in Australia over the last 20 years
- Explain the different types of documents required to disclose information to clients
- Describe the approach to financial services licensing in Australia
- Explain the different types of financial product advice
- Outline the regulatory requirements for sophisticated, professional or experienced investors
- Summarise other regulations governing the financial services industry
- Describe the role of compliance in the operation of a financial services organisation.

1 Financial services regulation

Before we consider the regulation of financial services, let us examine some of the fundamental characteristics of financial products that affect why we have regulation and how financial services are regulated.

1.1 Characteristics of financial products

Financial products, such as securities, are different from physical or tangible investments, such as property:

- They are created, rather than produced from physical inputs.
- They can be issued in virtually unlimited quantities.
- The can be issued virtually without cost.
- They are nothing in themselves, but represent an interest in "something else". So, an issue of shares is an issue of ownership interests in a company; an issue of units in a managed investment scheme is an issue of interests in the underlying assets of the particular managed investment scheme.
- They are not used up or consumed by clients.

Therefore:

- investors need to have an accurate idea of what the "something else" represents when they buy it. Information about the underlying assets – the company represented by the shares, the underlying assets in a managed investment scheme – must be disclosed to the investor
- investors need a continuous flow of information about the financial products once they have acquired them. So, once shares have been issued to investors, the company must continually provide information on the company to keep the investors up to date with matters which are pertinent to the future of the company
- the regulation of financial products needs to take account that they are uniquely susceptible to manipulation and deceptive practices.

1.2 Why regulate financial markets?

Table 5.1: Reasons for regulating financial markets

	Macro (market-wide rules)	Micro (individual businesses and financial intermediaries)
To pursue economic *stability*	• Controls over financial exchanges (e.g. the ASX), clearing houses (e.g. ASX Clearing) and securities settlement systems (e.g. the ASX CHESS system)	• General rules on the stability of all businesses and entrepreneurial activities • Specific rules on the special nature of financial intermediation (e.g. risk-based ratios for banks, limits to some portfolio investments and regulation of off-balance sheet activities, such as bank-issued hybrid securities)
***Transparency* in the market, between intermediaries and for investor protection**	• Rules imposing equal treatment (e.g. governing takeovers and offers of securities to the public) • Rules on the correct dissemination of information (e.g. insider trading, market manipulation, rules regarding the structure of exchanges and how prices are determined in any securities market)	• Rules aimed at non-discrimination in relationships among intermediaries and different customers (e.g. conduct of business rules on the ASX)
Safeguarding and promoting *competition* among financial intermediaries	• Controls over the structure of competition in the markets	• Regulations governing industry concentration, cartels and the abuse of dominant market positions

To achieve its broad objectives, the government aims to promote the most efficient and cost-effective financial services for users, consistent with financial market stability, prudence, integrity and fairness. As well, it aims to ensure that financial system providers are able to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovations. Increasingly, the regulators are concerned with the corporate culture of regulated organisations (e.g. how the organisations embed the values that underpin financial regulation).

1.3 Principles of financial market regulation

In financial markets in Australia, the following broad principles regarding market regulation are observed:

- *Rules-based law* – this is based on the concept that laws and regulations are clear, predictable and accessible, and form the parameters of what constitutes proper or illegal conduct
- *Principles-based regulation* – the underlying principles or reasons for the regulation are followed to achieve the objectives of the regulation. This approach contrasts with a strict adherence to “black letter law” or rules-based law that may encourage financial markets participants to limit their adherence to the law to the strict wording of the specific regulations, rather than the underlying regulatory principles
- *Disclosure* – this is based on the concept that the best outcome will be achieved if users of financial services are provided with sufficient information to enable them to make their own financial decision
- *Use of self-regulation where possible* – this is achieved through the use of self-regulatory organisations, such as industry and professional associations that act to monitor and enforce conduct in the specific areas in which they operate.

1.4 Types of financial market regulation

Regulation of the financial system takes four main types:

1. Regulations to promote *financial market integrity*
2. *Competition regulation* (e.g. mergers and acquisitions, and anti-competitive conduct)
3. *Prudential regulation* (of some financial organisations). The purpose of prudential regulation is to ensure that financial organisations are able to meet financial promises that they make (such as repaying deposits, or meeting insurance claims)
4. *Consumer protection regulation*. Although the ultimate objective of all financial regulation is to protect consumers, this relates to detailed financial product disclosures, specific requirements covering financial transactions with consumers and establishing dispute resolution arrangements. It includes regulations designed to protect depositors in the event of the failure of a financial institution.

1.5 Who regulates financial markets?

Two broad types of bodies regulate financial markets in Australia – government regulatory organisations and self-regulatory organisations (SROs).

1.5.1 Government regulatory organisations

The key government regulatory organisations are:

Australian Securities and Investments Commission

The Australian Securities and Investments Commission (ASIC) enforces and regulates company and financial services laws to protect consumers, investors and creditors.

An independent Australian government body, ASIC has regulated financial markets, securities, futures and corporations since January 1991. It subsequently became responsible for consumer protection in superannuation, insurance, deposit taking and consumer credit. The ASIC directly supervises trading markets such as the ASX market.

Australian Prudential Regulation Authority

The Australian Prudential Regulation Authority (APRA) has responsibility for the control of prudential requirements for banks and other Authorised Deposit-taking Institutions (ADIs), Life and General Insurance, Friendly Societies and Superannuation Funds (excluding Self-Managed Superannuation Funds).

Australian Transaction Reports and Analysis Centre

The Australian Transaction Reports and Analysis Centre (AUSTRAC) is Australia's anti-money laundering and counter-terrorism financing regulator and specialist financial intelligence unit. The two key areas it effectively regulates are the gambling sector and the financial sector.

Australian Taxation Office

The Australian Taxation Office (ATO) administers tax legislation and is responsible for regulating all self-managed superannuation funds.

1.5.2 Self-regulatory organisations

Government policy supports the active work of SROs. Self-regulation is said to be effective because of the following:

- industry-specialised knowledge of SROs
- SROs have an incentive to operate a fair, financially sound and competitive marketplace. Reputation and competition are powerful motivating forces for sustained proper behaviour
- the contractual relationship that an SRO has with the individuals and entities that it regulates can be powerful, with a global reach, and may mean the observance of ethical standards that go beyond government regulations. Generally, SROs can be more flexible than government organisations and can respond more quickly to major issues
- transparency and accountability of SRO compliance programs
- self-regulation allows for more diversity in methods of compliance with rules and regulations than may be possible for government regulators
- coordination and information sharing between SROs help to bring together different interests on specific regulatory issues.

Limitations on the effectiveness of SROs include the inherent conflicts that may exist between managing the needs of different stakeholders: government, investors, consumers and the industry.

Financial sector SROs in Australia include:

- The ASX Limited (ASX) – operates Australia's primary national stock exchange for equities, derivatives and fixed interest securities. The ASX governs listed companies and the on-exchange or on-market trade execution by brokers
- Financial Services Council (FSC) – covering fund managers
- Australian Superannuation Funds Association (ASFA) – covering superannuation funds
- Australian Financial Markets Association (AFMA) – covering participants in exchange traded and over-the-counter wholesale financial markets
- Institute of Actuaries of Australia (IAA) – covering actuaries
- CPA Australia (CPA), Chartered Accountants Australia and New Zealand (CAANZ) and the Institute of Public Accountants (IPA) – each covering accountants
- The Stockbrokers and Financial Advisers Association of Australia (SAFAA) – covering stockbrokers and financial advisers
- Finance and Treasury Association (FTA) – covering corporate treasury professionals
- The Financial Planning Association of Australia (FPA) and the Association of Financial Advisers (AFA) – professional associations whose members are financial planners
- The Australian Custodial Services Association Limited (ACSA) – the peak industry body representing members of Australia's custodial and investment administration sector.

2 Evolution of financial regulation in Australia

2.1 Financial Services Reform Act

Australia is highly regarded in terms of its financial services regulatory framework.

This reputation reflects the significant structural changes to regulatory arrangements that took place in March 2002 under the *Financial Services Reform Act 2001* (Cth) (FSRA).

A range of reforms to the regulatory framework was introduced following recommendations made by a Financial System Inquiry (Wallis Inquiry). The Wallis Inquiry had a mandate to examine likely future directions and changes in the financial sector and to determine the implications for effective financial sector regulation.

The most fundamental of these reforms was a restructuring of the responsibilities for oversight of the financial system. An important feature of these changes was to delegate responsibility for supervision of the sector along functional (what services they provide) instead of institutional lines (what types of institution they are).

The key objective of the reform process was to create a regulatory framework that was as streamlined and efficient as possible while maintaining high standards of market integrity and consumer protection. The framework also had to be flexible enough to facilitate the high level of innovation required of financial institutions operating in an increasingly global and competitive marketplace.

The aim of FSRA was to:

- create a harmonised licensing, disclosure and conduct framework for all financial service providers, and
- establish a consistent and comparable financial product disclosure regime.

FSRA aimed to ensure that Australia's regulatory framework kept pace with best practice developments in both the international and domestic financial services industries. The reforms also established comparable financial product disclosure requirements across all industry segments.

Under FSRA, APRA maintained its responsibility for the control of prudential requirements for the financial services sector, whilst ASIC held responsibility for the regulation of financial services, products and markets. The reforms introduced by FSRA included:

- uniform regulation of all financial products
- a single licensing framework for financial services providers
- uniform disclosure requirements for all financial products provided to retail investors
- minimum standards of conduct for providers dealing with clients
- flexible arrangements for the authorisation of market operators and the operation of clearing and settlement facilities.

These reforms were a significant step toward simplifying the regulatory environment and thereby reducing the costs of compliance, facilitating the entry of new market participants and the introduction of new services and products.

The key outcome of this approach was a set of common principles applying to:

- the regulation of deposit style products, such as bank accounts
- risk management products, such as insurance and derivatives
- investment products, including superannuation and managed investments.

The reforms aimed to bring flexibility and simplicity to the licensing of group structures, and to the delivery of financial services as a whole.

Licensees are now subject to a variety of obligations when they, or their representatives, deal with retail clients. These include requirements for:

- product disclosure
- point of sale disclosure
- needs-based advice
- compensation arrangements (arrangements in place for compensating your clients for loss they suffer if you breach your legal obligations)
- dispute resolution procedures
- handling of client funds.

The disclosure regime was similarly transformed, with Product Disclosure Statements (PDS) replacing the various requirements that previously governed unit trusts, superannuation funds and insurance products.

ASIC indicated that in enforcing the law, it will stridently enforce conduct which is, or is likely to:

- materially harm or disadvantage consumers; and/or
- undermine the confident and informed participation of consumers in the financial market.

ASIC expects financial service providers to follow the spirit and substance of the new regulations, particularly where there might be some uncertainty as to how a regulation applies (principles-based regulation). Financial service providers should act fairly, especially where their conduct involves retail clients.

Since the Wallis Inquiry, the sector has been transformed by forces such as domestic and international economic and financial crises, a substantial regulatory reform agenda, the growth in superannuation, changes in industry structure, new competitive dynamics, technology, innovation and broader macroeconomic trends.

2.2 Changes resulting from the 2008 market downturn

One outcome of the global market downturn in 2008 was a number of government-sponsored reviews arising directly from issues that arose during the downturn. As a result of these issues, the Commonwealth Government introduced the following regulatory changes:

- Commonwealth regulation of consumer credit
- addition of 'margin lending facilities' as a financial product under the licensing regime
- a 'responsible lending' obligation on lenders
- ASIC to take over supervision of securities and futures markets (e.g. the ASX) in Australia.

2.3 Future of Financial Advice

Following collapses such as Storm Financial and Opes Prime, a public inquiry into the failure of investor protection was held. It recommended further investor protections. The Labor Government introduced the Future of Financial Advice (FoFA) changes effective from 1 July 2013.

2.3.1 Summary of the FoFA reforms

In February 2009, the Rudd Government initiated an inquiry into issues associated with the provision of financial products and services in Australia (Ripoll Inquiry).

A wide range of issues were investigated including the role of financial advisers, commission arrangements relating to product sales and advice; the adequacy of licensing arrangements for financial product and service providers; consumer information and protection relating to financial services and products; and the need for any legislative or regulatory changes. As a result, the FoFA reforms were introduced.

2.3.2 The key elements of the reforms[1]

The FoFA reforms focused on improving the quality of personal financial product advice to retail clients, particularly product recommendations, and expanding the availability of more affordable forms of advice. The reforms aimed to improve investor protection and instil confidence in the financial advice industry. The reforms were designed to tackle conflicts of interest that had threatened the quality of financial advice which had been provided to Australian investors.

Table 5.2: Key components included in the FoFA reforms

Component	Description
Best interest duty	The introduction of a statutory client best interest duty means that advisers are required to act in the best interest of their retail clients and place their clients' interests ahead of their own when developing and providing personal advice. Financial advisers can establish that they have met this requirement by undertaking a number of specified steps to assist in determining what the best interests of the client are. These seven specified Safe Harbour steps are outlined in Section 5 – 'Types of Advice' later in this topic. If advisers seek to establish that they have met the best interests duty by taking these steps, they must also take any other reasonable steps if it would have been in the best interests of the client to do so at the time the advice was given. The best interests duty is based on the notion of 'reasonableness'. For example, advisers are only required to make 'reasonable inquiries' to obtain accurate information from the client and conduct a 'reasonable investigation' into relevant financial products. This is designed to protect advisers from clients claiming that the adviser should have done something onerous or unreasonable in order to act in their best interests.
Opt-in and fee disclosure	For new clients, advisers are required to request their retail clients to opt-in, or renew, their advice agreements every two years if clients are paying ongoing fees. In addition, for all ongoing clients, an annual statement, a Fee Disclosure Statement (FDS), outlining the fees charged and services provided in the previous 12 months must be provided to clients paying ongoing fees. This means advisers will be in regular contact with their clients and will need to demonstrate the value of the services they are providing their clients.

[1] Department of Treasury (2012), *Future of Financial Advice,* futureofadvice.treasury.gov.au

Component	Description
Ban on conflicted remuneration	This reform sees the introduction of a ban on conflicted remuneration, including commissions. This means that licensees and Authorised Representatives are not be allowed to give or receive payments or non-monetary benefits from a product manufacturer if the payment or benefit could reasonably be expected to influence financial product recommendations or financial product advice provided to retail clients. Exceptions to the ban on conflicted remuneration are provided in certain circumstances (e.g. for insurance advice). Volume payments (payments dependent on the total number or value of financial products of a particular class or classes) are presumed to be conflicted but it will be open to advisers to prove that they are not. This reform aims to encourage financial advisers to become more client-focused, as more of their fees will be paid directly by the client rather than indirectly through product commissions.
Ban on soft-dollar benefits	This reform sees the introduction of a ban on non-monetary ('soft-dollar') benefits given to advisers who provide financial product advice to retail clients. There are exceptions to the ban for benefits such as (subject to qualifying criteria): • Information technology support or software; • Education and training; and • Benefits that are below $300 in value.
Scaled advice	Through these reforms, the Government hopes to facilitate the expansion of limited, or scaled, advice both within and outside of superannuation. Scaled advice is advice about a specific area of a client's needs, for example insurance, or about a limited range of issues. This is in contrast to traditional 'holistic' advice where advice is provided on all aspects of the client's financial circumstances in a full financial plan. It is expected this will enable consumers to access beneficial advice at an affordable cost.

2.4 Financial System Inquiry 2014

In 2013, the Commonwealth Government flagged a new broad-based Financial System Inquiry into the financial sector (The Murray Inquiry) to update the approaches to regulation implemented in FSRA which followed the earlier Wallis Inquiry. The objectives of the Murray Inquiry were to 'best position Australia's financial system to meet Australia's evolving needs and support economic growth…. and offer a blueprint for an efficient and resilient financial system over the next 10 to 20 years, characterised by the fair treatment of users.'

The Inquiry asserts that Australia's financial system has performed well since the Wallis Inquiry and has many strong characteristics. But it also has a number of weaknesses:

- Taxation and regulatory settings distort the flow of funding to the real economy;
- It remains susceptible to financial shocks;
- Superannuation is not delivering retirement incomes efficiently;
- Unfair consumer outcomes remain prevalent; and
- Policy settings do not focus on the benefits of competition and innovation.

The Federal Government announced in October 2015 that it planned to implement most of the Murray Inquiry recommendations.[2] The recommendations cover banking and financial services. The key recommendations specifically applicable to financial services include:

- Superannuation measures:
  - These are examined across various *RG146 Superannuation* topics.
- Innovation measures:
  - Developing fundraising regulation to facilitate crowdfunding for both debt and equity
  - Encouraging industry efforts to expand credit and the wider availability of access to people's credit records
  - Reducing disclosure requirements for large listed bodies corporate issuing 'simple' bonds and encourage the standardisation of terms and conditions for such bonds.
- Consumer outcomes measures:
  - Introducing a targeted and principles-based product design and distribution obligation to enhance consumer protection
  - Providing ASIC with a financial product intervention power to enable it to modify, or if necessary, ban harmful financial products where there is a risk of significant consumer detriment. (Some commentators suggest that structured products and Contract for Differences could be in the regulator's sights)
  - Facilitating innovative product disclosure to consumers

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[2] Department of Treasury (2015), *Government response to the Financial System Inquiry*, http://www.treasury.gov.au/PublicationsAndMedia/Publications/2015/Govt-response-to-the-FSI/html, accessed 30 January 2017

  - Better aligning the interests of financial firms and consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice
  - Raising the competency of financial advisers and enhancing the Financial Advisers Register. Following legislative changes, financial advisers will be required to:
    - Hold a degree and undertake a professional year;
    - Pass a national exam and undertake continuous professional development;
    - Subscribe to a code of ethics.

    The use of the terms 'financial adviser' and 'financial planner' will be restricted to those listed on the Financial Advisers Register (there are exemptions to this restriction for financial advisers giving personal advice to wholesale clients)
  - Improving disclosure to consumers on general insurance, particularly on home contents insurance
  - More clearly differentiate products offered by finance companies (e.g. debentures) from deposit products offered by ADIs such as banks, credit unions, etc.
  - Renaming 'general advice' (e.g. which is more in the nature of 'sales'), though the actual term is to still be decided
  - Requiring mortgage brokers to adequately disclose ownership structures, e.g. where a bank owns a chain of mortgage brokers.
- Regulatory system measures (various):
  - We will not cover these matters relating to the management and funding of the regulator in this module.
- Other changes include:
  - Amending the definition of basic deposit products to remove current confusions for some deposit products.

3 Disclosure Documents

As previously outlined, disclosure is one of the key principles of how financial services regulation is carried out in Australia.

Documents providing disclosure on financial services depend on whether the advice being provided is personal advice or general advice, and on whether the advice is being provided to retail clients or wholesale clients.

3.1 Providing financial product advice to retail clients

The following three documents may be provided to a retail client by a financial services provider.

1. Financial Services Guide (FSG)
2. Statement of Advice (SOA)
3. Product Disclosure Statement (PDS).

3.1.1 Financial Services Guide

The FSG discloses the types of services that a retail client will be receiving. The FSG provisions are designed to ensure that retail clients are given sufficient information to enable them to decide whether to obtain financial services from the providing entity. The FSG must be provided to the client before providing a financial service to them (although there are some limited exceptions).

3.1.2 Statement of Advice

An SOA must be given to a retail client following the provision of personal advice. The SOA must include:

- The advice
- The basis on which the advice was given
- The adviser's name and contact details
- Specific requirements, including the name and contact details of the licensee's principal
- Information on remuneration and benefits payable to any person
- Details of information that might have influenced the adviser in providing the advice
- An appropriate warning if the advice is incomplete or based on inaccurate information
- Information on replacing one product with another.

3.1.3 Product Disclosure Statement

A PDS is prepared by, or on behalf of, the issuer or seller of the financial product and must contain sufficient information so that a retail client may make an informed decision about whether to purchase a financial product. A PDS contains:

- Significant risks of the product
- Fees, expenses and charges
- Taxation implications
- Any other information that could influence the client.

ASIC encourages product issuers to consider the Good Disclosure Principles when preparing a PDS. These principles state that any disclosure should:

- Be timely
- Be relevant and complete
- Promote product understanding
- Promote product comparison
- Highlight important information
- Have regard to consumers' needs.

3.2 Providing general advice to retail clients

When providing general advice to retail clients, an FSG must be provided.

If the adviser is providing general advice – such as in a seminar – the client must be provided with a general advice warning that the advice does not take into account the client's circumstances, namely that:

- The advice has been prepared without taking into account the client's objectives, financial situation or needs;
- The client should therefore consider the appropriateness of the advice, in light of their own objectives, financial situation or needs, before following the advice; and
- If the advice relates to the acquisition or possible acquisition of a particular financial product, the client should obtain a copy of, and consider, the PDS for that product before making any decision.

3.3 Providing general advice to wholesale clients

There is no specific legislative or regulatory requirement to provide a disclosure document when providing general advice to wholesale clients. It may be prudent, though, for an adviser to acknowledge this fact before providing the advice.

When providing general advice to wholesale clients some organisations provide a PDS; however, an Information Memorandum or Terms Sheet is normally provided.

4 Licensing

4.1 Why have licences in the financial services industry

ASIC grants an Australian Financial Services (AFS) Licence which permits people or companies to legally carry on a financial services business, including advising or dealing in financial products. Investors and other users of financial services are better protected if things go wrong and have access to free dispute resolution services. Holding an AFS Licence does not mean that ASIC endorses the company, financial product or advice, or that the investor cannot incur a loss from the investment. ASIC grants an AFS Licence if a business shows it can meet basic standards such as training, compliance, supervisory arrangements, maintaining adequate resources and dispute resolution. The business is responsible for maintaining these standards.

4.2 Who must be licensed?

The *Corporations Act 2001* (Cth) (the Act) requires people who provide financial services to obtain an AFS licence or become a representative of a licensee.

Under the Act, a person provides financial services if they carry out certain activities (e.g. advising or dealing) in relation to “financial products”.

Both natural persons and bodies corporate may apply for and hold an AFS Licence, although generally, most licensees are companies. If a company is an Authorised Representative of an AFS licensee, it may sub-authorise individuals (e.g. its directors or employees) to provide financial services on behalf of the licensee, but only if the licensee consents to the authorisation.

Under Section 916A of the Act, a person may be authorised as a representative of a licensee. A person includes a company, a natural person, a partnership and a group of individuals that act as trustee. A trust fund is not allowed to be an Authorised Representative, as only a natural person, body corporate, partnership and a group of individual trustees may be Authorised Representatives. The trustee(s) of the fund may be authorised, i.e. an individual, body corporate or multiple individuals.

Organisations providing financial services with “system, repetition and continuity” need to hold an AFS Licence.

4.3 Scope of AFS Licences

ASIC grants an individual or company an AFS Licence in order for them to provide financial services. The following are examples of different types of financial services:

- Providing financial product advice
- Dealing in a financial product
- Making a market for a financial product
- Operating a registered scheme
- Providing a custodial or depository service
- Providing traditional trustee company services – e.g. preparing estate management functions.

We will briefly examine the two most common of these:

4.3.1 Providing financial product advice

Financial product advice is a recommendation or statement of opinion intended to influence a person in making a decision in relation to a particular financial product or class of financial products. The context of the recommendation, how you are remunerated, and any representations made to the person are all relevant in deciding whether you are providing financial advice.

If a communication does not involve a recommendation or a statement of opinion, it is not financial advice. If a communication is objective, factual information, whose accuracy cannot be reasonably questioned, this will generally not involve expressing an opinion and will not therefore be financial product advice. If, however, the information is presented in such a way as suggesting or implying a recommendation to buy, sell or hold, it may amount to financial product advice.

Note that the onus is on the person or organisation providing the information on a particular financial product, or class of financial products, to determine whether, or not, it is financial product advice.

4.3.2 Dealing in a financial product

Dealing in a financial product includes:

- Applying for or acquiring a financial product;
- Issuing a financial product;
- Underwriting of securities or managed investment schemes;
- Varying a financial product; or
- Disposing of a financial product.

Arranging for a person to engage in one of the above examples of dealing is also dealing. You may be arranging where:

- Your involvement in the chain of events leading to the relevant dealing is of sufficient importance that without that involvement the transaction would probably not take place.
- Your involvement significantly “adds value” for the second person.
- You receive benefits that depend on the decisions made by the second person.
- You are not dealing when you deal on your own behalf, unless you are a product issuer, such as a fund manager, dealing in your own products.

4.4 Example of AFS Licence authorisations

Here is an example of the licence authorisations for a large Australian investment manager specialising in international investments:

"This licence authorises the licensee to carry on a financial services business to

(a) provide general financial product advice for the following classes of financial products:

- (i) derivatives;
- (ii) foreign exchange contracts;
- (iii) debentures, stocks or bonds issued or proposed to be issued by a government:
- (iv) interests in managed investment schemes excluding investor directed portfolio services; and
- (v) securities;

(b) deal in a financial product by:

- (i) issuing, applying for, acquiring, varying or disposing of a financial product in respect of the following classes of financial products:
  - (A) derivatives;
  - (B) interests in managed investment schemes limited to:
    - (1) own managed investment schemes only; and
  - (C) securities; and
- (ii) applying for, acquiring, varying or disposing of a financial product on behalf of another person in respect of the following classes of products;
  - (A) derivatives;
  - (B) foreign exchange contracts;
  - (C) debentures, stocks or bonds issued or proposed to be issued by a government:
  - (D) interests in managed investment schemes excluding investor directed portfolio services; and
  - (E) securities; and

(c) operate the following kinds of registered managed investment schemes (including the holding of any incidental property) in its capacity as a responsible entity:

- (i) schemes that only hold the following types of property:
  - (A) derivatives; and
  - (B) financial assets;

to retail and wholesale clients."

4.5 Who does not need to be licensed?

Exemptions from holding a licence are available to those who:

- Provide advice as a representative of another licensee;
- Issue, vary or dispose of a financial product under an arrangement with a licensee;
- Are a product issuer who varies or disposes of a financial product at the direct request of the product holder, rather than through an intermediary;
- Provide general advice as a publisher (e.g. a newspaper);
- Provide a service only to wholesale clients and are regulated by APRA which supervises this service; or
- Deal on their own behalf.

4.6 The Authorised Representative

The holder of an AFS Licence may authorise an individual, body corporate or partnership to provide particular financial services or products on their behalf. An Authorised Representative can offer some or all of the financial services and products of the licensee.

A licensee's obligations to its representatives cover its principals, directors and employees as well as external entities, such as Authorised Representatives. As a consequence, a licensee is responsible for the actions of its Authorised Representatives. Therefore, when discharging its duties in regard to monitoring, supervising and training its representatives, it needs to ensure that both internal and external representatives are taken into account.

4.7 General obligations of AFS Licence holders

The over-riding obligation of AFS Licence holders is to do all things necessary to ensure that you provide financial services *efficiently, honestly and fairly*.

They must also:

- Comply with their AFS licence conditions
- Take reasonable steps to ensure representatives comply with the financial services laws
- Have adequate resources (including financial, technological and human resources) to provide the financial services covered by the licence and to carry out supervisory arrangements
- Maintain their competency to provide financial services
- Train their representatives and ensure they continue to remain competent to provide the financial services
- Have a suitable dispute resolution system, if they provide financial services to retail clients
- Have adequate risk management systems in place
- Have compensation arrangements where they provide financial services to retail clients
- Notify ASIC if they are in breach of their licence obligations
- Provide appropriate disclosure documents to retail clients, where applicable
- Meet consumer protection requirements of ASIC.

Note that the licence holder is ultimately responsible for all the financial services provided under its AFS licence, regardless of how they are provided. The primary obligation to ensure compliance with the financial services laws rests with licensees who are responsible for the conduct of their representatives.

5 Types of advice

5.1 Personal advice

Advice is personal advice when the provider "has considered one or more of the person's objectives, financial situation and needs".

Advisers must have a reasonable basis for the personal advice they provide if they:

- Record full details of the client's position in a Fact Find[3]
- Carry out a thorough needs analysis and formulate appropriate recommendations
- Diligently record all relevant details
- Prepare clear advice for the client
- Obtain the client's decision and implement it.

A Fact Find is not always needed. Examples of situations where a Fact Find is not needed include:

- If the client is *wholesale*
- A genuine "no advice" sale
- A sale of life insurance which is exempt from the general provisions of the Life Code
- When providing oral advice within the parameters of an SOA
- Where a client only wants limited advice (in which case the Fact Find can be limited).

Advisers use information in the Fact Find to determine the strategy and products that best meet the client's needs. They must always analyse the needs, circumstances and objectives of the client to provide appropriate specific advice.

The advice must be given to the client in writing. It must state:

- The information obtained
- The relevant research
- The recommendations
- The reasons for the recommendations.

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3 A Fact Find is the process by which the adviser gathers information to assist the provision of a plan to the retail client.

Under the requirements of the Act, written advice is called a “Statement of Advice”.

Quality advice is based on two principles:

1. The suitability rule
2. Informed consent.

The suitability rule is effectively the “know your client” and “know your product” or reasonable basis rule. It requires that the adviser:

- Make sufficient inquiries of the client’s personal circumstances
- Consider the client’s personal circumstances
- Advise the client what other services they may need to obtain (e.g. taxation, legal)
- Consider the client’s tolerance for risk.

Informed consent involves the adviser communicating advice in a clear and concise way, so that the client fully understands the advice given and provides consent with full knowledge of that advice. Advice must not be misleading or incomplete. It must not be provided in a high-pressure environment.

When providing any personal advice the person providing the advice must meet the following four ‘best interest’ duties:

1. Act in the best interests of the client
2. Provide the client with appropriate advice
3. Warn the client if the advice is based on incomplete or inaccurate information
4. Prioritise the interests of the client.

Formerly this obligation lay solely with the licensee, however, it now extends to the actual person who is providing the advice.

5.1.1 The 7-Step Safe Harbour process

If an advice provider can show that they have taken the following seven steps they are considered to have complied with the best interest duty:[4]

Step 1

Identify the objectives, financial situation and needs of the client that were disclosed by the client.

[4] RG 175.248 in ASIC (2013), *RG 175 Licensing: Financial product advisers — Conduct and disclosure*, asic.gov.au (Regulatory resources / regulatory guides), pp 67-68

Step 2

Identify:

- The subject matter of the advice sought by the client (explicitly or implicitly); and
- The objectives, financial situation and needs of the client that would reasonably considered relevant to advice sought on that subject matter in the client's relevant circumstances.

Step 3

If it is reasonably apparent that information relating to the client's relevant circumstances is incomplete or inaccurate, make reasonable inquiries to obtain complete and accurate information.

Step 4

Assess whether the advice provider has the expertise required to provide the client with advice on the subject matter sought, and if not, decline to provide the advice.

Step 5

If it would be reasonable to consider recommending a financial product, an adviser needs to:

- Conduct a reasonable investigation into the financial product that might achieve the objectives and meet the needs of the client that would reasonably be considered relevant to advice on that subject matter
- Assess the information gathered in the investigation.

Step 6

Base all judgements in advising the client on the client's relevant circumstances; and

Step 7

Take any other step that at the time the advice is provided would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

5.2 Scaled advice

'Scaled advice' is personal advice that is limited in scope.

All personal advice is 'scaled', or 'limited in scope' to some extent. Retail clients rely on personal advice and may suffer significant loss if the advice is not of good quality.

The concept of 'scaled' advice has emerged in recent years. Previously, most advisers understood personal advice to mean that comprehensive advice must be provided if the adviser is providing personal advice. Scaled advice is limited in scope and is not comprehensive. Scaled advice as personal advice, must, however, meet the four best interest duties and related obligations listed above.

So, for example, it is possible to limit the scope of the advice to a single issue on which the client has sought advice. However, advisers must use their judgement when deciding on the scope of the advice. This must be consistent with the client's relevant circumstances and the subject matter of the advice the client is seeking. This means that the inquiries into the client's relevant circumstances can be limited or expanded, depending on the subject matter of the advice sought and the relevant circumstances.

Advisers can provide scaled advice:

- If the AFS Licence under which the advice is provided is broader in scope;
- To existing, new and potential clients; and
- To the same client, on multiple occasions, including after having previously given the clients relatively comprehensive advice, general advice or factual information.

So, less extensive inquiries are likely to be needed when the advice is a relatively simple purpose; more extensive inquiries are likely to be necessary when the advice involves complex financial products or strategies.

More inquiries are likely to be required when it is evident to the adviser that:

- The client has limited capacity to understand the advice
- The client has indicated conflicting objectives
- The client is confused about their objectives
- There is an apparent mismatch between the client's objectives and the advice or product being considered by the client.

More extensive inquiries are likely when the potential negative impact on the client is likely to be relatively serious or if the advice is inappropriate and inconsistent with the client's relevant circumstances.

ASIC also stresses the importance of the communication of the advice to the client:

- Advisers must take reasonable steps to ensure that they communicate clearly to clients the type of service they are providing, that is, whether they are giving them information, general advice or personal advice
- If advisers are giving scaled advice, they must explain what advice they are providing and what advice they are not providing
- ASIC considers that scaled advice will be unlikely to meet the best interests duty and related obligations if the client does not understand any of the significant limitations or qualifications that apply to the advice.

5.3 General advice

General advice is advice that is not personal advice.[5]

A representative of a licensee can provide general advice to a client, provided the adviser warns the client that it is general advice and not personal advice that considers their personal situation. The warning must be given to clients at the same time and by the same means that the advice is provided.

[5] ASIC (2012), *RG 244 Giving information, general advice and scaled advice*, asic.gov.au (Regulatory resources / regulatory guides), page 15

An adviser can provide general advice to a client even if the adviser has personal information about the client. If the adviser clarifies with the client when providing the advice that it is not providing personal advice and in fact the client's objectives, financial situation or needs are not considered, then the adviser is not providing personal advice.

The 2014 Murray Inquiry recommended that 'general advice' be renamed so that investors understood that it was clearly not 'advice' but more in the nature of 'sales'.

5.4 Factual information

An adviser can provide factual information to a client even if the adviser has personal information about the client and uses that information to determine what factual information to provide. Factual information is information that can be determined objectively and whose truth or accuracy cannot reasonably be questioned. Factual information is not general advice or personal advice. You do not need to be licensed to provide factual information.

ASIC, in Regulatory Guide 244, provides the following example:[6]

Example B1: Providing factual information about financial products on a website

Scenario

An organisation without an AFS licence includes on its website a list of financial products of a particular class available from third-party product providers, together with some objectively ascertainable factual information about specific product characteristics, with the aim of providing useful information for consumers to assist them to make a decision about the class of financial product.

Commentary

Because the information is factual and does not involve a qualitative judgement about, or an evaluation or assessment of, the features of the products, it is not financial product advice.

The client should be encouraged to consider the appropriateness of the advice in the light of their own financial objectives, financial situation or needs before acting on the general advice. If the advice relates to the acquisition, or possible acquisition, of a particular financial product, the client should be provided with a Product Disclosure Statement (PDS) relating to the product.

6 Wholesale, professional or sophisticated investors

Sections 761G and 761GA of the Act set out the circumstances in deciding whether a person is a retail or wholesale client. Identification of a person as either a retail or wholesale client is central to ensuring a financial services licensee makes the appropriate level of conduct and product disclosure required to the client.

The level of disclosure and investor protection is necessarily much higher for retail clients than for wholesale clients, as is the level of investor protection.

There are three broad classes of clients who qualify as wholesale investors:

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[6] Ibid, page 11

1. Professional investors
2. Sophisticated investors
3. Experienced investors.

A “professional investor” is defined as a person who “controls $10 million”. ASIC interprets this so that:

- A person may fall within the definition as a result of controlling assets other than cash; and
- The time at which the value must be calculated is the time at which the financial service or financial product is provided. Licensees should be satisfied that the client's assets have the requisite value at that time; historical valuations may not be sufficient for this purpose.

Section 9 of the Act provides other examples by which a person or entity can satisfy the professional investor test, including if they are hold an AFS Licence, if they are a listed entity or a related body corporate of that entity.

A “sophisticated investor” is a person who obtains a copy of a certificate given within the preceding six months by a qualified accountant that states that they:

- Have net assets of at least $2.5 million; or
- Have a gross income for each of the last two financial years of at least $250,000.

Furthermore, a person is not a retail client if the price or value of the financial product is at least $500,000; or if the entity is not a small business. (A small business is defined as employing less than 20 people or 100 people if the business manufacturers goods).

An “experienced investor” is a person who considers that they have the necessary previous investment experience to be able to assess:

- The merits of the investment offered by a licensed entity;
- The value of an investment;
- The risks associated with holding an investment;
- Their own information needs regarding an investment;
- The adequacy of the information given by the licensed entity regarding an investment; and
- Based on their investment experience, have been assessed by a licensed entity as suitable as a wholesale client.

The client must also sign a written statement that they have agreed not to receive certain documentation from the licensee (e.g. a PDS), nor that there are any additional obligations that would normally arise if the client were retail.

Under the Act, it is assumed that financial services or financial products are provided to a person as a retail client *unless* the contrary is established. The onus is on the licensee and others seeking to rely on the professional investor definition to demonstrate that the client controls the requisite amount of assets at the relevant time. As a matter of good practice, licensees and others should retain documentation about the reasons why they consider the professional investor definition applies to their clients. The same applies to “experienced investors”.

The identity of the recipient of the financial service is not the key issue. If a person provides advice in relation to a financial product, they will need an AFS Licence (or will need to be the representative of a licensee), regardless of whether the client receiving the service is a wholesale or retail client.

The wholesale/retail client distinction is important in the context of the disclosure and conduct requirements, and to some particular licensing exemptions, but the class of client served does not generally affect the licensing question.

7 Relevant legal principles, e.g. *Corporations Act 2001* (Cth), *ASIC Act 2001* (Cth), *Privacy Amendment (Private Sector) Act 2000* (Cth)

7.1 Efficient, honest and fair

Advisers must act ‘efficiently, honestly and fairly’ when providing financial product advice.

Advisers must carry on their business in an efficient manner. Honesty includes issues of ethics, fiduciary duty and codes of conduct. Acting fairly means that advisers must not discriminate between clients.

7.2 Conflict of interest

Advisers must disclose anything to the client that the client may see as being likely to influence the impartiality of the advisers’ judgement and advice.

7.2.1 Possible types of conflicts of interest

Disclosure of possible conflicts of interest include:

- How the adviser is remunerated
- Other benefits the adviser may obtain (e.g. “soft dollar” rewards)
- Limits on the types of products the adviser can recommend
- Any links with product providers
- Any amounts that may be paid to third parties as a result of placing business.

ASIC has defined conflicts of interest as circumstances where some or all of the interests of people (clients) to whom a licensee (or its representative) provides financial services are inconsistent with, or diverge from, some or all of the interests of the licensee or its representatives. This includes actual, apparent and potential conflicts of interest.

7.2.2 Examples of conflicts of interest

- Licensee A has an interest in encouraging client B to invest in higher-risk products that result in high commissions, which is inconsistent with client B’s personal desire to obtain a lower-risk product.

- Licensee C has an interest in maximising trading volume by its clients (including client D) in order to increase its commission revenue, which is inconsistent with client D's personal objective of minimising investment costs.
- Licensee E is the trustee of a retail superannuation fund and has an interest in maximising the fees it earns from managing the fund (and therefore maximising the returns to its shareholders), but the beneficiaries have an interest in minimising the fees they pay as members of the fund.

7.2.3 Managing a conflict of interest

- Managing a conflict of interest does not mean eliminating the conflict completely.
- The three mechanisms that licensees would generally use to manage a conflict of interest are:
    1. Controlling the conflict of interest;
    2. Avoiding the conflict of interest; and
    3. Disclosing the conflict of interest.
- Robust information barriers (i.e. Chinese Walls) may help a licensee manage their conflicts of interest. They may allow a licensee to insulate one group of staff from the information or other circumstances that give rise to a particular conflict, so that the group is not affected by that conflict. To be effective, such barriers must actually prevent information being passed to the relevant group of staff. Chinese walls must be institutionalised and not transitory.

7.3 Professional codes and standards

Industry codes of conduct – generally drafted by professional or industry associations, assist the adviser to provide professional financial services.

A code is essentially a set of enforceable rules that sets out a progressive model of conduct and disclosure for industry members that agree to abide by the code. Codes should therefore improve consumer confidence in a particular industry or industries.

An effective code, according to ASIC, can be expected to "do at least one of the following:

a) Address specific industry issues and consumer problems not covered by legislation;

b) Elaborate upon legislation to deliver additional benefits to consumers; and/or

c) Clarify what needs to be done from the perspective of a particular industry or practice or product to comply with legislation."[7]

It is not mandatory for any industry in the financial services sector to develop a code. Where a code exists, that code does not have to be approved by ASIC. However, where approval by ASIC is sought and obtained, it will be a signal to consumers that this is a code they can have confidence in.

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[7] ASIC (2013*), RG 183 Approval of financial services sector codes of conduct*, asic.gov.au (Regulatory resources / regulatory guides), page 5

The following Codes of Practice and Conduct are in place:

- Code of Banking Practice
- Electronic Funds Transfer Code of Practice
- General Insurance Code of Practice
- General Insurance Brokers' Code of Practice
- Financial Planners Code of Ethics and Rules of Professional Conduct
- Internet Code of Conduct
- Consumer Credit Code.

For example, the Financial Planning Association of Australia’s Code of Ethics and Rules of Professional Conduct provide typical content in such a code:

- Integrity
- Objectivity
- Competence
- Fairness
- Diligence
- Professionalism
- Confidentiality
- Compliance

The Association of Superannuation Funds of Australia’s Code of Ethics, for example, requires members to conduct their business in line with the following:

- Deal fairly and honestly with all persons that you meet in the course of your business activities
- Act in compliance with and uphold the regulatory framework governing the operation of the superannuation industry
- Avoid conduct or practices likely to bring discredit upon yourself, your employer, clients/members or the superannuation industry
- Provide full disclosure of all relevant matters in your professional dealings and not knowingly disseminate false or misleading information
- Disclose any real or perceived conflicts of interest in your business dealings
- Safeguard the confidences of present and former employers, clients/members and colleagues
- Avoid false, misleading or exaggerated claims and refrain from comment or action that may injure the professional reputation of colleagues.

7.4 Adviser competency, experience and initial and ongoing training

ASIC Regulatory Guide 146 *Licensing: Training of financial product advisers* (RG 146) sets out minimum training standards for people who provide financial product advice to retail clients. These are called training standards.

The training standards must be met by:

a) Natural person licensees;

b) Natural person representatives of licensees; and

c) Natural persons who are authorised by a corporate authorised representative of a licensee,

who provide to retail clients:

d) Personal advice, and/or

e) General advice.

When applying for an AFS Licence or becoming an Authorised Representative of a licensee, advisers must demonstrate knowledge and skills competencies in the areas in which they will be providing advice. Specific competencies are specified by ASIC. In addition, they must maintain, update and develop their competencies through continuing training.

Refer to the earlier discussion on the government's response to the recommendations of the Murray Inquiry. These will involve the installation of higher standards for financial advisers and financial planners.

7.5 Supervision

All AFS Licence holders must adequately supervise their advisers. The supervision needs to be undertaken at a level which ensures that the adviser is "efficient, honest and fair" in their business dealings.

7.6 Hawking prohibitions[8]

The hawking prohibitions under the Act are designed to prevent high pressure selling of financial products to retail clients. Such high-pressure tactics can include 'badgering'[9] and 'boiler room' practices[10].

The hawking prohibitions are breached if:

- A person makes an offer to sell a financial product;
- The offer is made in the course of meeting with or a telephone call to a client or potential client; and
- The meeting or telephone call is unsolicited.

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[8] ASIC (2005), *RG 38 The hawking prohibitions*, http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-38-the-hawking-provisions/

[9] Tormenting by continual persistent attacks.

[10] When high-pressure salespeople use banks of telephones to call lists of potential investors in order to peddle speculative, even fraudulent, securities. A boiler room is called as such because of the high-pressure selling.

Financial products covered by the hawking provisions include securities (e.g. shares and debentures), managed investments (e.g. units in unit trusts) and other financial products (such as superannuation, life and general insurance, derivatives and deposit products).

The following are prevented by the hawking prohibitions:

- Unsolicited telephone calls
- Unsolicited meetings.

A meeting or telephone call is considered to be 'unsolicited' unless it takes place in response to a positive, clear and informed request from a consumer.

Unsolicited emails, letters, faxes, brochures or media advertisements (press, radio, television or internet) are not covered by the hawking provisions. When using these media, advertisers need to make sure that they comply with the following general consumer protection prohibitions:

- Unconscionable conduct;[11]
- Misleading or deceptive conduct; and
- Harassment or coercion.

7.6.1 Exemptions

- For *securities and managed investments*, an unsolicited meeting or telephone call is exempt from the hawking prohibitions if at least one of the following applies:
  - The offer is of listed securities or managed investments and is made by telephone by a representative of a licensee; or
  - A licensee through whom the consumer has bought or sold securities or managed investments in the previous 12 months makes the offer.
- For *other financial products*, a telephone call is exempt if *all* of the following provisions are met:
  - The call is made between 8.00am and 9.00pm and not made on Sundays or public holidays;
  - The consumer is not listed on the No Contact/No Call register maintained by the person or organisation making the offer;
  - The consumer is provided with an opportunity to be listed on the No Contact/No Call register and is able to select the time and frequency of any future calls;
  - The consumer is given a PDS before becoming bound to acquire the financial product;
  - The consumer has been informed of the importance of using the information in the PDS when deciding whether to acquire the financial product; and

[11] Unconscionable conduct is generally accepted to mean conduct that should not be done in good conscience. Unconscionable conduct is more than simply unfair or harsh – it must have an element of bad conscience. Australian courts have found transactions or dealings to be 'unconscionable' when they are deliberate, involve serious misconduct or involve conduct that is clearly unfair and unreasonable.

- The consumer is given the name and other contact details of the product issuer, an indication of the nature of the information in the PDS, and the option of electing to have any information in the PDS read out to them.

7.7 Insider Trading

'Insider trading' is the trading of certain financial products, defined as Division 3 Financial Products (e.g. securities and derivatives), while in possession of information that is not generally available and would be likely to have a material effect on their price or value if it were. The prohibition against insider trading extends to procuring trading or communicating that information where trading in the relevant financial products is likely to take place.

7.7.1 What is 'insider trading'?

- The insider possessed inside information;
- The insider knew it was inside information; and
- The insider buys or sells (or gets another person to do so).

7.7.2 What is 'inside information'?

- Information that is not generally available; and
- If it were, a 'reasonable person' would expect it to have a material effect on the price or value of the financial products.

7.7.3 Who can be an insider?

Anyone can be an insider, although directors, employees or advisers are more likely to be in such a position.

7.7.4 Why is preventing insider trading important?

As the then Chairman of ASIC said in August 2010, the underlying policy of the Act is (essentially) that markets should be organised in a way that encourages all investors to trust that they will be treated fairly. Any appearance that the markets allow insiders to trade using inside information against investors at large will harm the trust and discourage participation in those markets.[12]

7.7.5 Products to which insider trading laws apply (Division 3 Financial Products)

- Securities
- Derivatives
- Interests in a managed investment scheme

[12] ASIC Chairman, Tony D'Aloisio, at Supreme Court of Victoria Law Conference, 13 August 2010.

- Debentures, stocks or bonds issued or proposed to be issued by a government
- Superannuation products, other than those prescribed by the regulations
- Any other financial products that are able to be traded on a financial market.

7.7.6 Principles which insider trading violates

The main purposes of the insider trading prohibitions in the Act are to:

- Give all market participants equal access to information;
- Underpin the fiduciary duty of company officers to the company and shareholders;
- Prevent damage to market integrity;
- Promote economic efficiency, and
- Prevent damage to a company that issues securities, its shareholders and investors.

7.7.7 What is prohibited?

The insider possessing the inside information cannot apply for, acquire or dispose of Division 3 Financial Products, either directly or indirectly, using inside information.

An insider can be either a natural person or a corporation. The insider can be anyone and they do not have to be directly related to the company. In practice, officers and directors are more likely to be in possession of inside information.

7.7.8 Examples of insider trading

Trading on corporate information - a person is aware of material information (e.g. takeovers, profit results, changes in forecasts) relating to a company that has not yet become public information and trades on the basis of the inside information.

Front running - a person, who is aware of a large order in a stock which is likely to have a price impact, trades in that stock, or a related derivative, before the large order is executed and then exits that position during or following execution of that order.

7.7.9 Implementing safeguards against insider trading

Corporate Chinese Walls

A body corporate does not contravene Section 1043A(1) of the Act by entering into a transaction or agreement at any time merely because of information in the possession of an officer of the body corporate if:

a) The decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer;

b) It had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and

c) The information was not so communicated and no such advice was so given.

7.7.10 Preventing insider trading

Corporations and their directors and officers, including Responsible Managers, ought seriously to consider implementing and reviewing the following areas to minimise the opportunity for and risk of insider trading:

- Creating and managing a disclosure policy for information material to the company that complies with the Act and ASIC guideline principles;
- Having a policy for the management of conflict of interest issues that arise in relation to Division 3 Financial Products, and
- Seeking independent legal advice in relation to applying for, acquiring or selling Division 3 Financial Products that may breach the prohibitions on insider trading.

7.8 Privacy

The *Privacy Act 1988* (Cth) (the Privacy Act) regulates the way many private sector organisations collect, use, keep secure and disclose personal information. It gives individuals the right to know what information an organisation holds about them and a right to correct that information if it is wrong.

7.8.1 The *Privacy Amendment (Enhancing Privacy Protection) Act 2012* (Cth)

The *Privacy Amendment (Enhancing Privacy Protection) Act 2012* (Cth) became law in December 2012. This introduced a new statutory regime with mandatory privacy principles with which all relevant businesses must comply. These principles are known as the Australian Privacy Principles (or APPs).

The APPs apply to all direct selling organisations with a minimum annual turnover of $3 million that must:

4. Have a privacy policy tailored to meet the requirements of the APPs.
5. Not use or disclose any information they may hold about an individual for direct marketing, subject to specific exceptions.
6. Before providing an overseas organisation (including related companies) with personal information, take reasonable steps to ensure that the overseas recipient complies with the APPs.
7. Have in place an adequate scheme allowing access to complaints.
8. Comply with requirements regarding unsolicited information.

Moreover, the amendments to the Privacy Act grant greater enforcement powers to the Australian Privacy Commissioner. The Commissioner will be able to obtain enforceable undertakings[13] from an organisation and apply to a court for a civil penalty order against organisations in breach of the Privacy Act. These penalties can range from $110,000 up to $1.1 million.

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[13] Enforceable undertakings are undertakings given to and accepted by a regulator that are enforceable in a court. The regulator generally accepts them as an alternative to civil or administrative action where there has been a contravention of the legislation that the regulator administers.

7.8.2 Australian Privacy Principles

The APPs set out obligations with which direct selling organisations (DSOs), with a minimum annual turnover of $3 million, must comply relating to the collection, storage, security, use, disclosure, access and correction of personal information acquired by an "organisation". Broadly speaking, personal information is any information that can identify a person.

DSOs with an annual turnover of less than $3 million will also be required to comply with the APPs if they trade in personal information (for example through buying or selling mailing lists) or are related to a larger company.

A short summary of the Australian Privacy Principles is included:

9. *Open and transparent* management of personal information.
10. *Anonymity and pseudonymity* – individuals have the option of not identifying themselves when dealing with a business which must met these privacy requirements.
11. *Collection of solicited personal information* – the information must be reasonably necessary for the entity’s activities. Sensitive information must not be collected unless the individual consents to giving the information.
12. *Dealing with unsolicited personal information* – must apply the same test as for Principle 3, above.
13. *Notification of collection of personal information* – must notify the person that you have collected the information and details of the information you have collected and why it has been collected.
14. *Use or disclosure of personal information* – the information collected must not be disclosed to another person without the consent of the person to which the information relates.
15. *Direct marketing* – information held about a person must not be disclosed for direct marketing purposes.
16. *Cross-border disclosure of personal information* – if disclosing personal information to a person or organisation overseas, the entity must make sure that the overseas entity does not breach the Australian Privacy Principles.
17. *Adoption, use or disclosure of government related identifiers* – an organisation must not use government-related identifiers of an individual as its own identifier for that individual.
18. *Quality of personal information* – information collected about a person must be accurate, up-to-date and complete.
19. *Security of personal information* – information collected about a person must be protected from misuse, unauthorised access and disclosure.
20. *Access to personal information* – if an organisation holds information about an individual it must give the person access to that information.
21. *Correction of personal information* – if information is inaccurate, out of date, incomplete, irrelevant or misleading it must be corrected.

7.8.3 The European Union General Data Protection Regulation

The European Union General Data Protection Regulation (the GDPR) contains new data protection requirements that apply from 25 May 2018. These requirements harmonise data protection laws across the EU and replace existing national data protection rules. The introduction of clear, uniform data protection laws is intended to build legal certainty for businesses and enhance consumer trust in online services.

The GDPR and the Australian *Privacy Act 1988* share many common requirements, including to:

- implement a privacy by design approach to compliance
- be able to demonstrate compliance with privacy principles and obligations
- adopt transparent information handling practices.

There are also some notable differences, including certain rights of individuals (such as the 'right to be forgotten') which do not have an equivalent right under the Privacy Act.

Who will the GDPR apply to?

The GDPR applies to the data processing activities of businesses, regardless of size, that are data processors or controllers with an establishment in the EU. Generally speaking, a controller[14] says how and why personal data is processed and a processor acts on behalf of the controller. Where a business has 'an establishment' in the EU, activities of the business that involve processing personal data will need to comply with the GDPR, regardless of whether the data is actually processed in the EU.

The GDPR also applies to the data processing activities of processors and controllers outside the EU, regardless of size, where the processing activities are related to:

- offering goods or services to individuals in the EU (irrespective of whether a payment is required)
- monitoring the behaviour of individuals in the EU, where that behaviour takes place in the EU (Article 3).

Data controllers and processors that are covered by the GDPR, but not established in the EU, will generally have to appoint a representative established in an EU member State (some exceptions apply). The representative is the point of contact for supervisory authorities and individuals in the EU on all issues related to data processing, to ensure compliance with the GDPR. Australian businesses with customers in the EU, or that operate in the EU, should confirm whether they are covered by the GDPR, and if so, take steps to ensure compliance by May 2018.

Examples—the GDPR on Australian businesses

Australian businesses of any size may need to comply if they have an establishment in the EU, if they offer goods and services in the EU, or if they monitor the behaviour of individuals in the EU. Examples of Australian businesses that may be covered by the GDPR include:

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[14] 'Controller' means the natural or legal person, public authority, agency or other body which, alone or jointly with others, determines the purposes and means of the processing of personal data; and 'processor' means a natural or legal person, public authority, agency or other body which processes personal data on behalf of the controller (Article 4, GDPR).

- an Australian business with an office in the EU
- an Australian business whose website targets EU customers, for example, by enabling them to order goods or services in a European language (other than English) or enabling payment in euros
- an Australian business whose website mentions customers or users in the EU
- an Australian business that tracks individuals in the EU on the internet and uses data processing techniques to profile individuals to analyse and predict personal preferences, behaviours and attitudes.

What information does the GDPR apply to?

The GDPR applies to 'personal data'. This means 'any information relating to an identified or identifiable natural person'. This has similarities with the definition of 'personal information' in the Privacy Act, which is defined as 'information or an opinion about an identified individual, or an individual who is reasonably identifiable' (s 6(1) of the Privacy Act).

Example: The GDPR makes clear that a wide range of identifiers can be 'personal data' including a name, an identification number, location data, an online identifier or one or more factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of that natural person.

What are some of the new requirements in the GDPR?

Outlined below are some of the new and enhanced requirements in the GDPR:

- expanded accountability and governance requirements
- a new definition of consent
- mandatory data breach notification
- requirement for data controllers to give individuals a range of prescribed information about the processing of their personal data
- a range of new and enhanced rights for individuals
- new direct obligations on data processors
- personal data may be transferred outside the EU to countries or international organisations that provide an adequate level of data protection
- sanctions[15].

For further detail about the GDPR, refer to the following resource from the Office of the Australian Information Commissioner website: https://www.oaic.gov.au/resources/agencies-and-organisations/business-resources/privacy-business-resource-21-australian-businesses-and-the-eu-general-data-protection-regulation.pdf

[15] This section has been sourced from the OAIC resource, 'Australian businesses and the EU General Data Protection Regulation' (Updated June 2018)

7.9 Anti-money laundering

Money laundering and, increasingly, terrorist financing, are areas of great concern, and countries look for techniques to detect, prevent and stop these activities. The techniques used for both types of activities are the same, with large efforts made to conceal the source and subsequent use of funds. One major difference is that for terrorist financing the original source of funds may be legitimate.

Money laundering occurs in all countries and especially where there are lax or ineffective anti-money laundering regulations. Different parts of the money laundering process may also occur in various countries in an effort to make funds harder to trace to source. The global size of the problem is extremely large and most countries, including Australia, treat these issues very seriously and provide large resources to address the problem.

7.9.1 Money laundering

AUSTRAC has defined money laundering as:

- The process by which illicit source monies are introduced into an economy and used for legitimate purposes.
- Illicit money describes the proceeds of any sort of crime and money laundering occurs through a variety of methods with the aim of making the money appear to have a legitimate source.
- Tax evasion is also considered to be money laundering, even if the money was originally legitimately obtained.

There are three general types of money laundering:

22. *Internal* – where proceeds of crimes in Australia are laundered in Australia.
23. *Incoming* – where proceeds of overseas crime is brought into Australia for laundering.
24. *Outgoing* – where proceeds of crime in Australia are sent overseas for laundering.

7.9.2 Unsophisticated money laundering techniques

- Placement of large sums of money in bank accounts.
- Physical movement of currency from one jurisdiction to another.

7.9.3 Impact on financial sector

Money laundering can have an adverse impact on the development of the financial sector in a variety of ways, including:

- Manipulation of the banking systems, as has occurred in central and eastern Europe.
- Fraudulent activities by employees.
- Corruption by criminal elements.
- Distortion of the market with the introduction of illicit funds.
- Volatility and instability.
- Perceived risk to depositors and investors.
- Reputation risk.

7.9.4 Counter measures against money laundering

The best counter measure for countries is to implement an effective framework for detecting and prosecuting money laundering and terrorist financing activities.

Counter measures include:

- Customer identification.
- Reporting of amounts of cash over a certain threshold.
- Reporting currency movements into and out of the country.
- Suspect transactions reports lodged by financial institutions.
- Criminal prosecution for money laundering.
- Confiscation and forfeiture of money laundering proceeds.
- Cross border co-operation between regulators in different countries.

The *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) (the AML/CTF Act) introduced the obligations on financial businesses including:

- Requirements to identify and verify all new customers before undertaking a business transaction.
- Requirements to monitor customer transactions during their provision of the designated service to identify, mitigate and manage the risk that the provision of the designated service may involve or facilitate money laundering or terrorism financing.
- Requirements to undertake enhanced due diligence of customers as a result of higher identified risk factors.
- Extension of existing significant cash transaction reporting obligations to some non-cash transactions such as e-currency.
- Requirements to supply originator information in international funds transfer instructions (subject to certain exceptions).
- Requirements to report movements of bearer negotiable instruments to AUSTRAC if requested to do so by a police officer or customs officer. There is no threshold for the bearer negotiable instruments reporting requirement.
- Expansion of existing “suspicious transaction” reporting obligations to “suspicious matter” reporting as not all designated services under the AML/CTF Act involve transactions.

The basic approach of the AML/CTF Act is risk-based with financial institutions responsible for assessing the risk of money laundering in their own organisations and taking appropriate measure to manage these risks. Reporting entities are required to develop “risk-based” systems and controls.

The risk-based approach recognises that financial companies have the most experience and knowledge of how to assess and implement measures to reduce the risk of money laundering and terrorism financing. It also allows industry the flexibility to adapt to risks that change over time, and is easier for most legitimate customers.

The AML/CTF Act places key obligations on providers of financial services that are at risk of exposure to money laundering or terrorism financing.

The cornerstone of the AML/CTF regime is that businesses ‘know their customers’. The regime requires reporting entities to carry out customer identification and verification procedures. Reporting entities have to carry out customer “due diligence” which will require that reporting entities monitor customer transactions on an ongoing basis.

Other important obligations include reporting obligations, under which businesses are required to report suspicious matters, international funds transfer instructions, and transactions which exceed the thresholds set in the legislation as well as record keeping obligations.

8 Compliance[16]

8.1 What is compliance?

Compliance is the provision of services that facilitate an organisation identifying and meeting its obligations whether they arise from:

- Laws;
- Regulations;
- Contract;
- Industry standards, or
- Internal policy.

Achieving effective and efficient compliance requires:

- Commitment and leadership from the Board and the CEO.
- Analysis of requirements and identification of risks, requirements and exposures.
- Development of systems and procedures.
- The creation of an organisation-wide compliance culture.

Cost-effective compliance is achieved when the organisational culture integrates compliance into the fabric of how business is conducted.

8.2 Why is compliance important?

Compliance is the cornerstone of good governance.

For us to have confidence in our financial institutions, in the suppliers of products and service we consume, in the actions of Government authorities, we must be able to trust that the organisations we deal with uphold the laws and values of our community – whether it is a massive multi-national, public utility, local council, small business or sole trader.

[16] Australian Compliance Institute

Compliance is not simply about meeting one's legal obligations. Nor should it be a monolithic, unproductive system that unreasonably burdens organisations. A properly implemented compliance system seamlessly integrates compliance, risk management, governance and ethics into the fundamental business processes, reducing risk and improving quality workflow.

8.3 Ethical culture[17]

An ethical culture operates in an organisation when it incorporates the values embodied in the whole regulatory structure.

These values lead to:

- Proper protection for consumers of financial services.
- Proper information for clients.
- Behaviour in the markets which maintain a high level of public confidence.
- Behaviour, which enables financial crime to be fought effectively.

The ethical culture is not just the observance of rules, but a culture, a set of ingrained values, attitudes and beliefs, which embrace the objective of regulation.

8.4 Implementing a compliance culture

Ways to help implement a compliance culture include:

- Incorporate compliance as part of each person's performance management plan.
- Embed compliance as part of the organisation's and each department's key performance indicators (KPIs).
- Train staff in the importance of compliance, and in legal and ethical issues involving compliance.
- Encourage and reward reporting of compliance failures and breaches, and encourage analysis of lessons from these failures to assist in future compliance.
- Encourage staff to suggest compliance improvements.
- Regularly survey to monitor compliance awareness.

8.5 Indicators of a compliance culture

The following indicators are likely to demonstrate an effective compliance culture:

- The board and senior management have compliance as a major objective.
- Compliance is regularly measured, and assessed, for effectiveness.
- The organisation admits to mistakes and fixes such mistakes.
- Staff view the compliance managers as friends, not as enemies.

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[17] A. Newton, *Compliance is not enough: getting the ethical culture right in your firm*, Securities Institute, London, 2001

- Compliance breaches are reported, not hidden.
- Management continually works with the compliance department in a proactive way and not just when a problem arises.
- Staff who report compliance breaches are rewarded, not penalised.
- Compliance training occurs regularly for all staff.
- Staff who understand why compliance is important.

9 Complaints resolution procedures

The complaints resolution framework provides access to redress for Australian consumers, small businesses and superannuation fund members who have a complaint against a financial firm. Financial firms are required to have in place a dispute resolution system that consists of:

- internal dispute resolution (IDR) procedures that meet the standards or requirements made or approved by ASIC; and
- membership of one or more ASIC-approved external dispute resolution (EDR) schemes.

ASIC Regulatory Guide 165 Licensing: *Internal and external dispute resolution* covers complaints resolution. This guide explains what AFS licensees, unlicensed product issuers, unlicensed secondary sellers, credit licensees, credit representatives, unlicensed carried over instrument lenders (unlicensed COI lenders) and securitisation bodies must do to have a dispute resolution system in place that meets ASIC's requirements.

9.1 Internal Dispute Resolution (IDR)

Under the dispute resolution provisions, entities subject to those provisions must have in place procedures that comply with ASIC's requirements, which:

d) Satisfy the Essential Elements of Effective Complaints;

e) Appropriately document the procedures, and

f) Have a system for informing those who complain about the availability and accessibility of the relevant external dispute resolution scheme.

Licensees must take into account: (a) the size of their business; (b) the range of financial services that they offer; (c) the nature of their customer base; and (d) the likely number and complexity of complaints in setting up their dispute resolution procedures.

As a minimum, any internal dispute resolution procedure must be able to deal with complaints made by *"retail clients"*. Wherever possible, a licensee should seek to resolve complaints directly with its clients through its own procedures. It is better for all parties that a complaint is dealt with at the earliest possible stage.

To make IDR procedures as transparent and accessible as possible and to assist with staff training and awareness, a licensee must document its IDR procedures.

For a dispute resolution system to be fully effective, a licensee needs to establish appropriate links between individual internal procedures and the relevant external dispute resolution scheme for those complaints that you cannot resolve directly.

The benefits of effective internal dispute resolution procedures with broad coverage include:

g) To resolve complaints quickly and directly;

h) To identify and address recurring or systemic problems, which can thus lead to product or service improvements;

i) To provide solutions to problems rather than have remedies imposed by an external body; and

j) Improved levels of customer confidence and satisfaction.

9.2 External dispute resolution (EDR)

Currently, the external dispute resolution schemes that have been approved by ASIC are the Financial Ombudsman Service and the Credit and Investments Ombudsman. A third service is also relevant—the Superannuation Complaints Tribunal is an independent tribunal set up by the Commonwealth Government to deal with complaints about superannuation funds, annuities and deferred annuities, and retirement savings accounts. Its scope does not extend to self-managed superannuation funds.

9.2.1 The Australian Financial Complaints Authority (AFCA)

On 9 May 2017, the Government announced that a new 'one stop shop' to deal with financial system complaints would be established in response to the Review of external dispute resolution and complaints arrangements in the financial system (the Ramsay Review). The Bill to establish this new 'one stop shop'—the Australian Financial Complaints Authority (AFCA)—was passed in Parliament in February 2018.

The Australian Financial Complaints Authority or 'AFCA' is the new single external dispute resolution (EDR) scheme for consumer and small business complaints.

AFCA replaces the three existing EDR schemes of the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and Superannuation Complaints Tribunal (SCT) so that consumers have access to a single EDR scheme.

Membership of AFCA will be required under law or a licence condition of a financial firm. Financial firms are required to have joined AFCA by 21 September 2018. AFCA will be operational and ready to start receiving complaints about all financial firms from 1 November 2018 and will:

- be the single point of contact for complainants for EDR services
- have higher monetary limits
- be more accountable to users, including by having an independent assessor to deal with complaints about its handling of disputes, and
- have rules (terms of reference) to support its dispute resolution functions and legislation in the case of superannuation disputes.

ASIC has released Regulatory Guide 267: *Oversight of the Australian Financial Complaints Authority*, a guide for its oversight of AFCA. This guide outlines ASIC's powers to issue regulatory requirements, give directions and approve material changes to the EDR scheme. It also sets out how ASIC will administer the reporting requirements in the AFCA Act including AFCA's obligation to refer matters to appropriate authorities, refer settled complaints and systematic issues and report on scheme statistics. No material changes can be made to the scheme without the approval of ASIC.

Transition arrangements

In the transition to the commencement of AFCA, complaints made to the FOS and CIO schemes will continue to be dealt with under the relevant scheme's terms of reference and rules that applied when the complaint was made. The SCT will continue to resolve open complaints for a period of time after the commencement of AFCA. Regulatory Guide 139: *Approval and oversight of external dispute resolution schemes* provides the framework for those versions of the terms of reference and rules. It will remain in force until all those complaints are closed. At that time, ASIC will withdraw RG 139.

Disclosure relief

ASIC has announced it will give financial firms, including superannuation trustees, transitional relief until 1 July 2019 to allow them time to update mandatory disclosure documents and periodic statements with the contact details of the Australian Financial Complaints Authority.

Under the disclosure relief provided by ASIC:

- financial firms will have until 1 July 2019 to update EDR details to refer to AFCA in mandatory disclosure documents, periodic statements and exit statements, and
- financial firms will not have to issue significant event notifications under s1017B of the Corporations Act associated with the transition to AFCA
- Regulatory Guide 165 Licensing: *Internal and external dispute resolution* (RG 165) has also been amended (issued 31 May 2018) to require information about predecessor schemes and AFCA to be provided to complainants from 21 September 2018. RG 165 should be read in conjunction with Regulatory Guide 139: *Approval and oversight of external dispute resolution schemes*.

Financial firms who wish to rely on the disclosure relief will need to review both the legislative instruments and the updated text in the box under RG 165.88[18].

[18] RG 165.88 refers to paragraph 165.88 in Regulatory Guide 165: *Licensing: Internal and external dispute resolution*

Review

On completion of this topic, participants should self-test their knowledge by answering the following questions.

- Explain why the financial services industry is regulated in Australia.
- Outline who regulates the different parts of the financial services industry.
- Summarise the major changes in financial services regulation in Australia over the last 20 years.
- Explain the different types of documents required to disclose information to investors and consumers.
- Describe the approach to financial services licensing in Australia.
- Explain the different types of financial services advice which are licensed in Australia.
- Outline the regulatory requirements for sophisticated, professional or experienced investors.
- Summarise other regulations governing the financial services industry.
- Describe the role of compliance in the operation of a financial services organisation.